

Opening Statement of

THOMAS J. MILLER
Attorney General of Iowa

Board of Governors
Federal Reserve System
Public Hearing

Pursuant to Section 158 of the
Home Ownership and Equity Protection Act of 1994

Home Equity Lending Market

Washington, D.C.
June 14, 2007

I wish to thank the Board for holding hearings on this important issue, and for inviting the views of a state attorney general. Predatory and abusive mortgage lending is an issue of great importance and one that the States have been at the forefront. In recent years, we have acted together with state banking regulators to attack abusive lending practices on a national level. Through our efforts, we obtained consumer relief amounting to \$484 million in our settlement with Household Finance and \$325 million in our settlement with Ameriquest Mortgage Company. These settlements also resulted in major reforms in the practices of these national subprime lenders and set standards that have been adopted by other lenders. Through these and other enforcement efforts the States have developed significant expertise on the widespread fraud and abuse that has occurred in the subprime mortgage market.

Reckless lending practices on the part of subprime brokers and lenders have led to a growing national foreclosure crisis. There are estimates that up to 2.2 million subprime homeowners may ultimately be foreclosed upon. Countless other borrowers are struggling to

meet payment terms and have had significant equity stripped from their homes. However, it is just as important for lenders and investors as it is for consumers to fix these market abuses. The last several years have created a race to the bottom in which unethical actors have been handsomely rewarded for their misdeeds and ethical actors have lost market share, in effect punishing them for refusing to engage in fraud. Effective regulations will create an even playing field in which ethical actors are no longer punished.

While many in the industry are touting that the market has corrected itself, and thus no further regulations are needed, assuming such a correction is in fact occurring, one must ask at what cost. How many hard working Americans have lost their family home, taken a second job, or otherwise struggle in order to keep up with their skyrocketing mortgage payment. The question for the Board is what lessons will be learned and what protections can be put in place so that when the inevitable next mortgage cycle begins, the abuses that have brought us here today will not be repeated. I urge you to enact comprehensive regulations that will protect vulnerable homeowners as well as lenders by prohibiting unfair and deceptive practices.

HOEPA was enacted thirteen years ago, which is an eternity in the mortgage market. The high cost price trigger structure of HOEPA is limited and does not address the market abuses that have evolved over time. I strongly recommend that in order to be effective any regulations cover all subprime loans, not just high cost loans.

The response by some of the industry is to argue for enhanced disclosures. I do not believe that enhanced disclosures can adequately protect consumers. Subprime originators have shown a propensity to engage in deception and misrepresentations which undermine even the best disclosures. While improved disclosures would help on the margins, they do not address the core problems. You cannot disclose your way out of the problem of predatory lending.

The Board has already identified the key areas for reform. I strongly support banning prepayment penalties for all subprime loans. Prepayment penalties are one of the most frequent areas of deception and abuse and serve to trap borrowers in unaffordable loans. In fact, Iowa has banned prepayment penalties since 1978, with no noticeable impact on access to credit.

I also support requiring escrows for taxes and insurance for all subprime loans. The absence of escrows presents an opportunity for deception that all too many originators are willing to use. There is no legitimate reason why subprime loans should not have escrows just like prime loans.

Similarly, I strongly support putting significant restrictions on stated income loans. Our investigations have revealed that stated income loans are the source of massive fraud and deception. Stated loans are a niche product that have been improperly applied to the market at large. They are used to fraudulently qualify borrowers for loans that by definition they cannot afford. Last year, around 42% of subprime loans were stated. This high level of use of stated income loans far exceeds their legitimate purpose.

Importantly, we have found that the fraudulent inflation of income is being done at the suggestion and initiative of the loan originator, not the borrower. In addition to the fraud, stated loans carry a higher interest rate than fully documented loans. Thus, stated income loans are not in the best interests of borrowers. I strongly recommend that stated loans be banned for all subprime loans, except for those borrowers who can prove that they are self-employed. This will benefit consumers because they will receive a lower rate, while still preserving the stated income option for those who truly need it.

Finally, I believe it is critical that all subprime loans are required to be underwritten at the fully indexed rate. The use of artificially low teaser rates on a hybrid ARM has led to disastrous

consequences. These loans were intended to fail, thus requiring the borrower who was about to experience payment shock to come back a mere 24 months later for another round of expensive origination and closing costs. Eventually this house of cards was destined to come down. Iowa is currently fourth in the country in subprime foreclosures, despite the fact that our unemployment rate is at or near a six-year low. Local economic conditions do not explain the high level of foreclosures in Iowa.

While I am very supportive of the Board's recognition of the need for lenders to underwrite loans to assure repayment capacity, this is nothing more than a return to market fundamentals. One would not think it necessary for regulators to have to tell lenders not to make loans that cannot be repaid. Requiring lenders to stop underwriting loans based on a temporary teaser rate will help consumers, lenders, and investors by encouraging sustainable homeownership.

These are clear cut solutions that will not interject uncertainty into the market and will not reduce access to credit. In fact, these proposals will only strengthen the subprime market by eliminating the fraudulent loans. Loans originated through unfair and deceptive practices ultimately do not perform, further demonstrating the connection between consumer protection principles and safety and soundness. Eliminating fraud is the single most effective way to preserve incentives for responsible lenders to provide credit to subprime borrowers. Thank you again for this opportunity.